

RatingsDirect®

Summary:

State of Washington; General Obligation

Primary Credit Analyst:

Jillian Legnos, Boston (1) 617-530-8243; jillian.legnos@spglobal.com

Secondary Contact:

Gabriel J Petek, CFA, San Francisco (1) 415-371-5042; gabriel.petek@spglobal.com

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Credit Profile

US\$499.09 mil various purpose go rfdg bnds ser R-2018D due 08/01/2035

Long Term Rating

AA+/Stable

New

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to the State of Washington's series R-2018D various-purpose general obligation (GO) refunding bonds. The outlook is stable.

The ratings reflect our view of Washington's:

- Relatively well-educated workforce and good income indicators;
- Good recent economic growth relative to that of the nation and sales tax-based revenue structure, which has demonstrated less sensitivity to economic cycles than income tax-reliant states;
- High cost of housing, especially in key economic centers that could impede long-term growth prospects;
- Good internal access to sources of liquidity in the treasury and treasurer trust funds;
- Strong financial policies and practices, including statutory provisions requiring that the state's biennial budget and projected subsequent two fiscal years' spending plans be balanced, which is key given increasing expenditure pressures; and
- Moderately high per capita debt burden, but relatively low unfunded pension and other postemployment benefit (OPEB) liability.

The state's full faith, credit, and taxing powers secure the GO bonds. We understand that the proceeds from the series R-2018D bonds will be used to refund certain debt outstanding for debt service savings.

As of Oct. 1, 2017, Washington has about \$17.6 billion in GO bonds outstanding, net of reimbursements. Of this, about \$6.3 billion of the state's net GO debt is payable first from excise taxes on motor vehicles and special fuels. Currently, the state also has about \$810 million of certificates of participation (COPs) outstanding, including COPs for state and local agencies. Appropriation-backed debt outstanding includes the city of Aberdeen's revenue refunding bonds for a Stafford Creek Corrections Center project and FYI Properties' lease revenue bonds for the Department of Information Services.

Washington's September 2017 Economic and Revenue Forecast Council (ERFC) forecast revised general revenue upward by \$2.4 billion for the 2017-2019 biennium to \$43.3 billion. Changes reflect \$2.1 billion of non-economic legislative changes and \$279 million of upward revenue revisions that stem from higher-than-expected collections in the current fiscal year (\$87 million) and changes to forecast (\$192 million). Total forecast 2017-2019 general fund revenue is 12.9% higher than that of the previous biennium, while the 2019-2021 biennium revenue forecast of \$47.4 billion is \$4.1 billion, or 9.6%, higher than the 2017-2019 biennium estimate. The ERFC's baseline scenario for the 2017-2019 biennium incorporates continued projected economic growth, including 1.2% nonfarm payroll employment

growth in 2018, 1.0% growth in 2019, and 0.8% growth in 2020, which reflects assumed gradual deceleration in the state economy as economic recovery matures. The September 2017 ERFC also incorporated modest growth in housing starts of 0.8% in 2018 and a slight 0.6% decrease in nominal annual personal income growth for fiscal 2018 to 4.5% from 5.1% in the June forecast. The ERFC's forecast 2018 and 2019 nominal annual personal income growth is particularly strong at 4.5% and 5.5%, respectively; it differs slightly from IHS Markit's projections of 4.2% in 2018 and 4.9% in 2019.

On June 30, 2017, Washington enacted its \$43.7 billion 2017-2019 biennium operating budget for the state general fund, education legacy trust account, and opportunity pathways account. The enacted budget is \$5.2 billion, or 13.5%, higher than the supplemental budget for the 2015-2017 biennium, due primarily to recommended increases to education spending in response to the Washington State Supreme Court's 2012 decision (the "McCleary" ruling), which opined that the state has systematically underfunded its public education system. The enacted budget allots a total of \$22 billion of biennial spending on kindergarten to grade 12 (K-12) education, which represents approximately 50% of the total budget. The 2015-2017 biennium budget made some progress in raising education spending to address a portion of Washington's obligations under the McCleary ruling. The state's 2017-2019 enacted budget includes education funding initiatives that management believes address the remaining requirements outlined in the ruling. Any action concerning the court's termination or maintenance of jurisdiction over the case is expected in the fall of 2017. Growth in spending also reflects funding for class size reduction, recommended employee salary increases, overhaul of the mental health system, various higher education costs, and collective bargaining and related compensation costs.

The 2017-2019 enacted biennium operating budget also includes revenue additions expected to bring in an additional \$2.07 billion over the biennium. Additions include increasing the state property tax rate to \$2.70 per \$1,000 of assessed value (\$1.614 billion) and certain changes to the state's sales tax collections (\$456 million). Washington now projects a combined budget stabilization fund and unrestricted general fund balance of \$2 billion at the close of the current biennium, or about 4.8% of biennial general fund expenditures (excluding federal expenditures), which we view as adequate. On an annualized basis, which is more comparable to other states, the ending biennium balance, as enacted, would equate to a strong 10% of general fund expenditures budgeted for fiscal 2018. We note that the enacted budget reduces reserves in the state's budget stabilization account by \$480 million (29.3%) to \$1.16 billion, from \$1.64 billion in the previous biennium, largely due to payments made into a pension fund to reduce liabilities. However, we believe Washington's current reserves position the state well for future cyclicity or an unexpected downturn.

The state legislature enacted a capital budget to refund existing appropriations, but has not yet passed a capital budget for new projects due to negotiations about rural water rights. The timeline for passage is uncertain and new capital projects will not begin until a full capital budget is in place. The state's \$5.7 billion transportation budget was passed in April 2017.

Washington's reliance on retail sales and business and occupation (gross receipts taxes) for a combined 69% of general fund revenues (on a budgetary basis) typically affords the state more revenue stability than other states that rely on personal income tax revenues. However, cyclicity in the economy could pressure revenue, as reflected in the ERFC's pessimistic economic scenario that reflects 5% lower revenue than currently estimated for the next biennium due to downside risks from a potential national recession, national and global political uncertainty, or a stock market crash.

Although state employment, personal income, and GDP trends remain positive, exposure to weakness in the global economy and effects on exports, as well as weaker manufacturing activity and volatile stock markets, remain mitigating risks to Washington's revenue forecast. The strong dollar and weak global economic growth contributed to declines in state exports in 2016. According to IHS Markit, state exports in 2016 were down 7.8% compared with 2015, including a 11.6% decline in transportation equipment exports, which was somewhat offset by improvement in agriculture exports. Washington is the third-largest exporter in the country, and the state's exports as a percent of gross state product) is the second-highest proportion in the country at 16.8%.

In general, we consider Washington's approach to financial management strong, as reflected in our financial management assessment (FMA) and budget management scores. Well-established economic and revenue forecasting and increasingly refined debt management practices and oversight served the state's credit quality well during the recession and its aftermath. Forward-looking state policies facilitate budget practices we view as prudent, including minimal reliance on payment deferrals or other one-time responses to anticipated budget gaps.

For September 2017, the state treasury and treasurer's trust fund's month-end cash balance was \$5.2 billion, compared to the average annual \$5.9 billion balance through September 2017. Investments are conservative, in our view, with an average of 58.8% of funds invested in U.S. treasuries and agencies as of September 2017. In addition to Washington's investment guidelines, state policies require that collateral in repurchase agreements (of which the state currently has none) for U.S. Treasury, agency, and money market instruments be priced at 102% of market value. Mortgage-backed repurchase agreements of more than seven days are subject to a higher, 105% requirement.

According to unaudited results for fiscal year-end 2017, Washington's gross direct tax-supported debt burden was \$20.3 billion in GO and appropriation-backed bonds outstanding, but a somewhat lower \$18.8 billion when accounting for self-supported debt. Tax-supported debt was moderately high, in our opinion, at about \$2,542 per capita and 4.8% of total personal income. Debt paydown remained average, in our view, with about 53% of principal outstanding amortized over 10 years. Gross GO and lease appropriation-backed debt service is moderate, in our opinion, at 4.7% of the funds' expenditures from which the state pays debt service. However, portions of Washington's debt are funded from self-supporting or reimbursable sources. Considering just the general fund, adjusted for these offsetting revenues, we estimate that debt service was a still-moderate, in our view, 5.4%. Even after recent issuance of about \$1.5 billion of additional debt since the end of fiscal 2016, we estimate the state's debt burden remains moderately high.

Long-term liabilities include those related to the state's pension system and retiree health care. Based on June 30, 2017, comprehensive annual financial reports for the cost-sharing plans, we calculate Washington's share of the net pension liability across 12 pension plans (not including a share of the school employees retirement system liability) totaled about \$2.5 billion as of June 30, 2017, or \$353 per capita, which is very low, in our view. This is reduced from approximately \$4 billion or \$553 per capita in fiscal 2016 after strong investment returns were reported for the 2017 fiscal year. Relative to total personal income, the state's share of the net pension liability was 0.7%, which is also what we consider very low. The aggregate funded ratio across plans, including cost-sharing plans in which the state participates as of June 30, 2017, is what we consider good at almost 87%, although this represents a slight decline from a funded level close to 91% as of June 30, 2014, and Washington's pension contributions have fallen short of actuarially determined contribution levels.

OPEBs are funded on a pay-as-you-go basis. The state's OPEBs produce an implicit liability by allowing retired employees to purchase health, life, and vision insurance in the same pool as current employees, at a subsidized rate.

Based on the analytic factors we evaluate for states, we have assigned Washington a composite '1.7' on a four-point scale whereby '1.0' is the strongest and '4.0' is the weakest.

Outlook

The stable outlook reflects our view of Washington continuing to benefit from above-forecast end-of-biennium revenue trends. Nevertheless, we expect that significant upward pressure on spending originating in legal- and voter-approved mandates will remain a soft point in the state's credit profile. However, legal requirements that Washington enact budgets that not only balance for the current biennium but also project balance through the following biennium help facilitate a structural approach. That, coupled with Washington's ongoing discipline vis-a-vis funding the state's budget reserves, should help insulate the state rating from unexpected economic or revenue weakening. Potential for upward movement would likely entail a permanent fix to Washington's education funding challenges, moderation of growth in debt levels, and sustainable growth in revenue that keeps pace with the state's underlying economic growth rates.

Downside pressure on the state rating would likely have economic origins. A sharp falloff in the housing market or sustained weak demand for key state exports, fueled in part by a strong U.S. dollar, changes in trade policy, or slower-than-expected growth from China, could all contribute to such a scenario. State policymakers' response to a downside economic scenario--whether it's timely and structurally oriented--would likely dictate any effect on our rating on Washington. If lawmakers delayed taking corrective action or relied extensively on one-time solutions to budget gaps, allowing the state's reserve balances to decline precipitously, this could result in downward pressure on the rating.

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